

The Budget Outlook

The Congressional Budget Office's (CBO's) new baseline projections indicate that if current laws and policies did not change, the federal budget would run a deficit of \$368 billion in 2005 and a smaller deficit, \$295 billion, next year. After that, annual deficits would gradually decline, turning into a small surplus by 2012, assuming that various tax increases occurred as scheduled. Relative to the size of the economy, the deficit would equal 3.0 percent of the nation's gross domestic product (GDP) this year and 2.3 percent of GDP in 2006. By 2015, the end of CBO's 10-year projection period, the baseline surplus would equal 0.7 percent of GDP (see Figure 1-1).

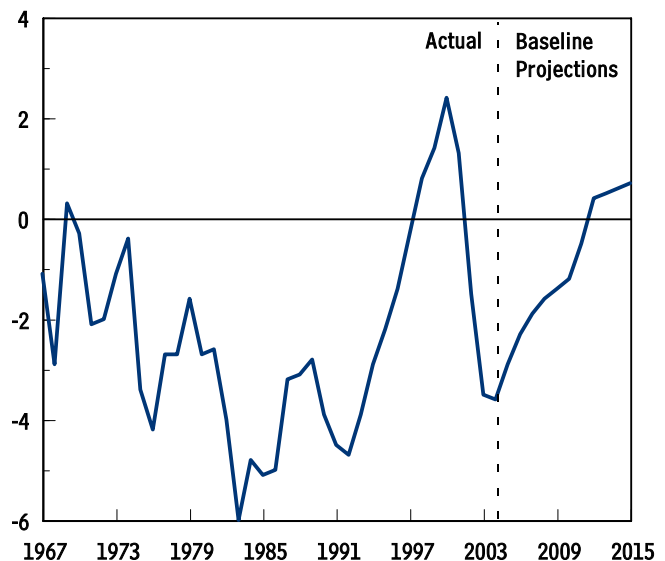
At first glance, the current baseline budget outlook may appear to have improved relative to CBO's previous projections, which were issued last September.¹ The cumulative deficit projected for the 2005-2014 period (the 10 years covered by the previous baseline) has declined from \$2.3 trillion to \$1.4 trillion. However, because of the statutory rules that govern baseline projections, the current baseline omits a significant amount of spending that will occur this year—and possibly for some time to come—for U.S. military operations in Iraq and Afghanistan and for other activities related to the global war on terrorism. Likewise, those rules may have led the September 2004 baseline to overstate such costs.

Under the Balanced Budget and Emergency Deficit Control Act of 1985, discretionary spending (spending controlled by annual appropriation acts) is projected by assuming that the most recent year's funding is continued in each subsequent year with adjustments for projected inflation. In 2004, supplemental appropriations provided \$115 billion for operations in Iraq and Afghanistan (and

Figure 1-1.

The Total Deficit or Surplus as a Percentage of GDP, 1967 to 2015

(Percent)



Source: Congressional Budget Office.

for other activities); in CBO's September baseline, that sum was extrapolated for each future year.² But so far in 2005, no appropriations have been provided for those operations. As a result, unlike the preceding projections, the

1. Those projections were published in Congressional Budget Office, *The Budget and Economic Outlook: An Update* (September 2004).

2. That \$115 billion, which included a small amount of funding unrelated to activities in Iraq and Afghanistan, comprised funding from two laws that provided supplemental appropriations for 2004. The first, enacted in November 2003, provided \$87 billion. The second, the Department of Defense Appropriations Act, 2005, provided another \$28 billion for 2004 (including \$1.8 billion from reversing a rescission that had previously been enacted but not yet applied). In addition, \$2 billion in supplemental funding for hurricane relief was provided in September, after CBO published its baseline.

Table 1-1.

Comparison of CBO's January 2005 and September 2004 Baseline Deficits or Surpluses

(Billions of dollars)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Total, 2005- 2014
Baseline Deficit (-) or Surplus as Projected in January 2005 ^a	-368	-295	-261	-235	-207	-189	-80	71	85	115	-1,364
Deficit (-) or Surplus as Projected in September 2004 and Adjusted to Exclude the Extension of Supplemental Appropriations ^b	-310	-202	-187	-183	-166	-142	-32	108	115	138	-861
Memorandum: Baseline Deficit as Projected in September 2004 ^b	-348	-298	-308	-318	-312	-298	-200	-70	-75	-65	-2,294

Source: Congressional Budget Office.

- a. Does not include additional funding for operations in Iraq and Afghanistan, which has not yet been requested for 2005.
- b. CBO's September 2004 baseline extrapolated \$115 billion in supplemental funding (mostly for activities in Iraq and Afghanistan) throughout the 2005-2014 period. Excluding the extension of such funding reduces outlays over that period by \$1.4 trillion (including debt-service costs).

current baseline includes only outlays for such activities that result from appropriations enacted for previous years.

Once further appropriations for those operations are provided, they are likely to add about \$30 billion to the deficit this year and possibly more next year. (For a discussion of one plausible path for future spending on military operations in Iraq and Afghanistan and the global war on terrorism, see page 9.) Thus, the 2005 deficit is likely to total around \$400 billion and the 2006 deficit well over \$300 billion. With that extra spending for military operations included, the 2005 deficit would amount to about 3.3 percent of GDP—compared with the deficit in 2004 of 3.6 percent of GDP.

Under identical assumptions about spending on Iraq, Afghanistan, and other activities related to the war on terrorism, the current baseline outlook is less favorable than the one presented in September: the total deficit projected for the 2005-2014 period has grown from \$861 billion to \$1.3 trillion—a rise of more than \$500 billion, or 0.3 percent of GDP (see Table 1-1). A number of factors account for that increase. The Working Families Tax Relief Act of 2004 (WFTRA)—which extended several

tax provisions, including the 10 percent tax bracket, marriage-penalty relief, and the increase in the child tax credit—added \$146 billion to the 10-year deficit, mostly by decreasing projected revenues.³ In addition, supplemental appropriations for 2005 provide \$11.5 billion in disaster relief for hurricane victims; extrapolating that budget authority through 2014 added \$94 billion to projected discretionary outlays. Revisions to the baseline caused by changes in CBO's economic forecast were fairly small, reducing the cumulative deficit by \$41 billion. Other, technical revisions to the baseline—mostly involving revenues—had a greater effect on the 10-year deficit, increasing it by \$173 billion.

In the current baseline, total outlays grow at an average rate of 4.3 percent a year and remain around 19 percent to 20 percent of GDP through 2015 (see Table 1-2). Within that total, mandatory spending (funding determined by laws other than annual appropriation acts) is projected to grow by 5.7 percent a year—faster than the

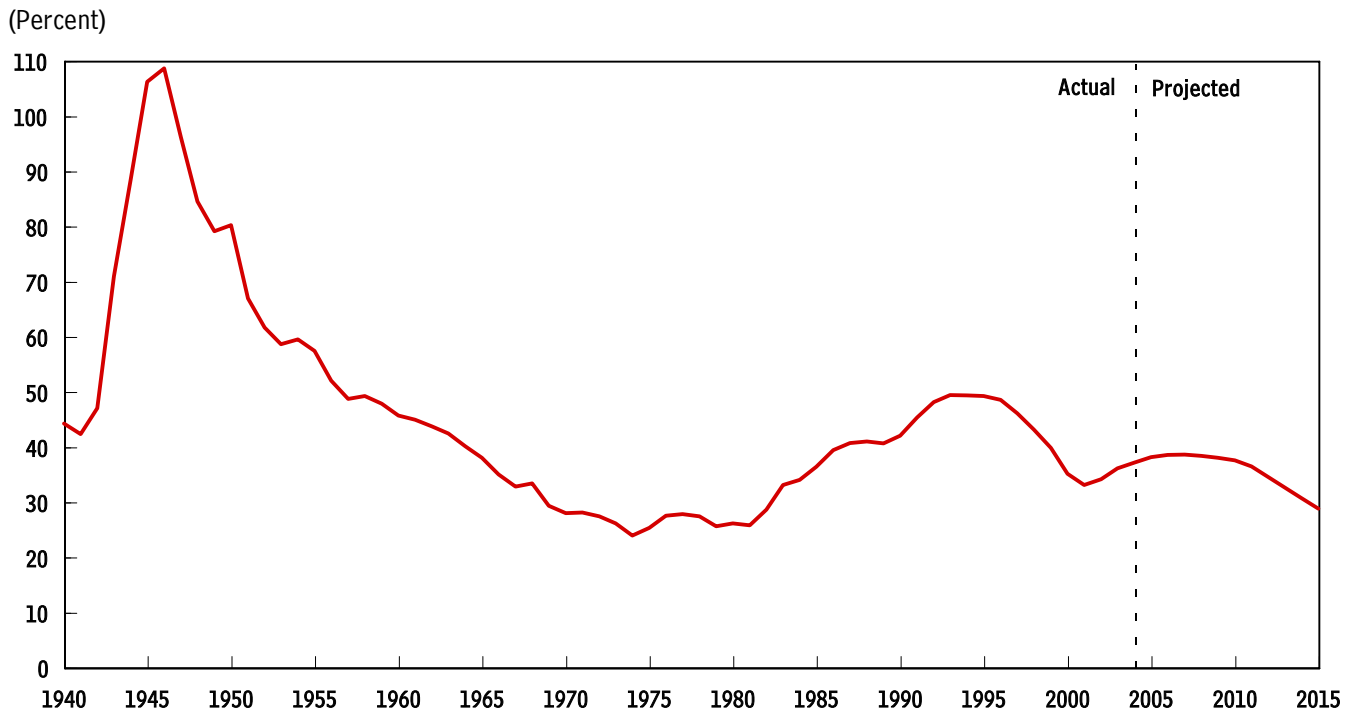
3. That estimate excludes additional debt-service costs (interest payments on federal debt) that result from the increase in projected deficits.

Table 1-2.**CBO's Baseline Budget Projections**

	Actual 2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	Total, 2006- 2010	Total, 2006- 2015
In Billions of Dollars														
Revenues														
Individual income taxes	809	899	986	1,082	1,172	1,265	1,362	1,561	1,718	1,822	1,932	2,048	5,867	14,947
Corporate income taxes	189	216	226	226	237	246	249	254	261	270	281	292	1,184	2,542
Social insurance taxes	733	790	833	876	918	962	1,009	1,054	1,102	1,151	1,202	1,253	4,598	10,360
Other	148	153	167	173	181	188	187	192	221	231	243	255	896	2,038
Total	1,880	2,057	2,212	2,357	2,508	2,662	2,806	3,062	3,303	3,474	3,657	3,847	12,545	29,888
On-budget	1,345	1,484	1,607	1,719	1,836	1,956	2,066	2,287	2,494	2,629	2,775	2,928	9,184	22,297
Off-budget	535	573	605	638	672	706	740	774	809	845	882	919	3,361	7,591
Outlays														
Discretionary spending	895	930	914	919	940	959	980	1,006	1,022	1,050	1,075	1,101	4,713	9,966
Mandatory spending	1,237	1,317	1,380	1,450	1,529	1,620	1,713	1,824	1,896	2,028	2,159	2,303	7,692	17,902
Net interest	160	178	213	249	274	289	303	311	314	311	308	303	1,328	2,875
Total	2,292	2,425	2,507	2,618	2,743	2,869	2,996	3,142	3,232	3,389	3,542	3,706	13,733	30,743
On-budget	1,913	2,024	2,092	2,190	2,300	2,409	2,517	2,644	2,711	2,841	2,965	3,097	11,508	25,766
Off-budget	380	401	415	428	443	460	479	497	521	548	577	609	2,225	4,977
Deficit (-) or Surplus	-412	-368	-295	-261	-235	-207	-189	-80	71	85	115	141	-1,188	-855
On-budget	-567	-541	-484	-471	-464	-454	-451	-357	-217	-212	-190	-169	-2,324	-3,469
Off-budget	155	173	190	210	229	246	262	277	289	298	305	310	1,136	2,614
Debt Held by the Public	4,296	4,665	4,971	5,246	5,494	5,716	5,919	6,012	5,955	5,884	5,784	5,658	n.a.	n.a.
Memorandum:														
Gross Domestic Product	11,553	12,233	12,888	13,586	14,307	15,029	15,757	16,494	17,245	18,023	18,826	19,652	71,566	161,806
As a Percentage of GDP														
Revenues														
Individual income taxes	7.0	7.3	7.7	8.0	8.2	8.4	8.6	9.5	10.0	10.1	10.3	10.4	8.2	9.2
Corporate income taxes	1.6	1.8	1.8	1.7	1.7	1.6	1.6	1.5	1.5	1.5	1.5	1.5	1.7	1.6
Social insurance taxes	6.3	6.5	6.5	6.4	6.4	6.4	6.4	6.4	6.4	6.4	6.4	6.4	6.4	6.4
Other	1.3	1.3	1.3	1.3	1.3	1.3	1.2	1.2	1.3	1.3	1.3	1.3	1.3	1.3
Total	16.3	16.8	17.2	17.3	17.5	17.7	17.8	18.6	19.2	19.3	19.4	19.6	17.5	18.5
On-budget	11.6	12.1	12.5	12.7	12.8	13.0	13.1	13.9	14.5	14.6	14.7	14.9	12.8	13.8
Off-budget	4.6	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7
Outlays														
Discretionary spending	7.7	7.6	7.1	6.8	6.6	6.4	6.2	6.1	5.9	5.8	5.7	5.6	6.6	6.2
Mandatory spending	10.7	10.8	10.7	10.7	10.7	10.8	10.9	11.1	11.0	11.3	11.5	11.7	10.7	11.1
Net interest	1.4	1.5	1.7	1.8	1.9	1.9	1.9	1.9	1.8	1.7	1.6	1.5	1.9	1.8
Total	19.8	19.8	19.5	19.3	19.2	19.1	19.0	19.0	18.7	18.8	18.8	18.9	19.2	19.0
On-budget	16.6	16.5	16.2	16.1	16.1	16.0	16.0	16.0	15.7	15.8	15.8	15.8	16.1	15.9
Off-budget	3.3	3.3	3.2	3.2	3.1	3.1	3.0	3.0	3.0	3.0	3.1	3.1	3.1	3.1
Deficit (-) or Surplus	-3.6	-3.0	-2.3	-1.9	-1.6	-1.4	-1.2	-0.5	0.4	0.5	0.6	0.7	-1.7	-0.5
On-budget	-4.9	-4.4	-3.8	-3.5	-3.2	-3.0	-2.9	-2.2	-1.3	-1.2	-1.0	-0.9	-3.2	-2.1
Off-budget	1.3	1.4	1.5	1.5	1.6	1.6	1.7	1.7	1.7	1.7	1.6	1.6	1.6	1.6
Debt Held by the Public	37.2	38.1	38.6	38.6	38.4	38.0	37.6	36.5	34.5	32.6	30.7	28.8	n.a.	n.a.

Source: Congressional Budget Office.

Note: n.a. = not applicable.

Figure 1-2.**Debt Held by the Public as a Percentage of GDP, 1940 to 2015**

Source: Congressional Budget Office.

economy as a whole. Discretionary appropriations, by contrast, are assumed simply to keep pace with inflation and, to a lesser extent, with wage growth. As explained above, however, the baseline does not include additional funding for military operations in Iraq and Afghanistan and for the global war on terrorism; thus, discretionary outlays are projected to increase by only 1.7 percent a year, on average, from the baseline level for 2005.

For revenues, CBO assumes—as baseline rules require—that the various tax provisions enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and modified by the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) and by WFTRA will expire as scheduled on December 31, 2010. As a result, revenues as a percentage of GDP are projected to rise slowly through 2010, from 16.8 percent to 17.8 percent, and then increase more rapidly in 2011 and 2012, reaching 19.6 percent of GDP by 2015.

Accumulated federal debt held by the public (mainly in the form of Treasury bonds) equals about 38 percent of GDP through 2010 in CBO's baseline. Thereafter, pro-

jections of shrinking annual deficits diminish the government's need to borrow, causing debt held by the public to decline to less than 29 percent of GDP by 2015 (see Figure 1-2).

Although the baseline projections are prohibited from incorporating anticipated policy changes, this chapter shows the budgetary implications of some alternative policy assumptions over the next 10 years. For example, if military operations in Iraq and Afghanistan and other activities related to the global war on terrorism were assumed to continue (but slow gradually) for the next few years rather than being excluded from the baseline altogether, the total deficit projected for the 2006-2015 period would increase from \$855 billion to \$1.4 trillion. Debt held by the public at the end of 2015 would equal almost 32 percent of GDP instead of less than 29 percent.

Similarly, if all of the tax provisions that are set to expire over the next 10 years (except for one related to the alternative minimum tax) were extended, the budget outlook for 2015 would change from a surplus of \$141 billion to

a deficit of \$282 billion.⁴ Debt held by the public at the end of 2015 would equal 38 percent of GDP, and the 10-year deficit would total \$2.7 trillion.

Over the longer term, demographic changes will put significant strains on the federal budget. Those strains are set to begin within the current 10-year projection period and intensify as members of the baby-boom generation age. In addition, the cost of health care for the elderly is likely to keep growing rapidly. As a result, the annual growth rate of Medicare spending is projected to increase from 6.2 percent in 2008 (after the prescription drug benefit has been fully phased in) to 8.3 percent in 2015. Spending for Medicaid also is estimated to grow by more than 8 percent a year at the end of the projection period. The annual growth of Social Security spending is expected to accelerate from around 4.5 percent in 2006 to 6.4 percent in 2015. Under baseline assumptions, those three programs together will account for 55 percent of all federal spending by 2015, up from 42 percent this year.

After 2015, as the percentage of the population age 65 or older continues to increase (from 14 percent in 2015 to 19 percent in 2030), spending on Social Security, Medicare, and Medicaid will claim an even larger share of total outlays, assuming that health care costs keep growing faster than the economy. Over the long term, the increasing resource demands of such programs will exert pressure on the budget that will make current fiscal policy unsustainable.⁵

A Review of 2004

The budget deficit continued to increase in 2004—growing to \$412 billion from the \$378 billion recorded for 2003. In relation to the size of the economy, the deficit was slightly bigger last year than in the previous year—3.6 percent of GDP versus 3.5 percent—but was smaller than the deficits of the mid-1980s and early 1990s (see Figure 1-1 on page 1).

4. That calculation does not assume extension of the higher exemption amounts for the alternative minimum tax that were established by JGTRRA through 2004 and extended by WFTRA through December 2005. Also, that calculation does not incorporate any impact on the overall economy.

5. For an detailed discussion of the long-term pressures facing the federal budget, see Congressional Budget Office, *The Long-Term Budget Outlook* (December 2003) and *The Outlook for Social Security* (June 2004).

Spending rose by more than 6 percent (or \$132 billion) in 2004, totaling almost \$2.3 trillion. Mandatory outlays grew by 5 percent (\$56 billion), with Medicaid spending rising by almost 10 percent and Medicare outlays growing by more than 8 percent. Discretionary spending increased by 8 percent (\$70 billion), led by outlays for defense, which rose by more than 12 percent (\$49 billion). Roughly half of that increase resulted from spending for military operations in Iraq and Afghanistan and for other activities considered part of the war on terrorism (see Box 1-1 for details about the funding provided for those operations thus far). Discretionary outlays not related to defense grew only half as fast in 2004 as they did in 2003: by less than 5 percent (almost \$20 billion). That growth was spread among numerous programs, with the largest increases occurring in the areas of international affairs (\$6 billion), education (\$4 billion), and health (\$3 billion). (Recent federal spending and projections through 2015 are discussed in detail in Chapter 3.)

After declining for three years, revenues increased in 2004 by 5.5 percent (or \$98 billion). Taxes on corporate income accounted for roughly 60 percent of that growth; receipts from those taxes were almost 44 percent higher last year than in 2003. Receipts from social insurance taxes rose by about 2.9 percent, and receipts from taxes on individual income grew by almost 2 percent. Taken as a whole, other sources of revenue grew by about 3 percent. (Chapter 4 provides more information about recent and projected federal revenues.)

The Concept Behind CBO's Baseline Projections

The projections that make up CBO's baseline are not intended to be predictions of future budgetary outcomes—rather, they represent CBO's best judgment of how the economy and other factors would affect federal revenues and spending if current laws and policies remained the same. CBO constructs its baseline according to rules set forth in law, mainly in the Balanced Budget and Emergency Deficit Control Act of 1985 and the Congressional Budget and Impoundment Control Act of 1974. In general, those laws spell out how CBO should project federal spending and revenues under current policies. The resulting baseline can be used as a neutral benchmark against which to measure the effects of proposed changes in tax and spending policies.

Box 1-1.**Appropriations for the Global War on Terrorism**

Since September 2001, the Congress has provided about \$197 billion in supplemental appropriations for military operations in Iraq and Afghanistan and for other activities in support of the global war on terrorism (see the table at right). Determining exactly how much of that budget authority has been spent is impossible because reports by the Department of the Treasury do not distinguish between outlays from regular appropriations and those from supplemental appropriations, nor do they distinguish between spending for peacetime operations and spending associated with the war on terrorism. Information from the Department of Defense (DoD) indicates that the department has obligated almost all of the \$171 billion appropriated before August 2004 for operations in Iraq and Afghanistan and for other activities in the war on terrorism. Additionally, DoD reported that through September 2004,

it had obligated \$1.9 billion of the \$26.8 billion appropriated in August as part of Public Law 108-287.

In fiscal year 2004, DoD obligated a total of \$71.3 billion—or almost \$6 billion per month—for Operations Iraqi Freedom, Enduring Freedom (in Afghanistan), and Noble Eagle (antiterrorism activities in the United States). Of that total, 80 percent was dedicated to Operation Iraqi Freedom, 14 percent to Operation Enduring Freedom, and 6 percent to Operation Noble Eagle. In all, half of the amount obligated in 2004 covered operation and support costs, such as for training, fuel, supplies, repair parts, maintenance of facilities, communications, and other contract services. Personnel costs accounted for another 31 percent of the total, 9 percent went for transporting troops and supplies, and the remaining 10 percent paid for new equipment and for construction projects.

For revenues and mandatory spending, the Deficit Control Act requires that the baseline be projected under the assumption that present laws continue without change.⁶ In most cases, the laws that govern revenues and mandatory spending are permanent. Thus, the baseline projections reflect anticipated changes in the economy, demographics, and other relevant factors that affect the implementation of those laws.

The baseline rules differ for discretionary spending. The Deficit Control Act states that such spending should be projected by assuming that the most recent year's discretionary budget authority is provided in each future year, with adjustments to reflect projected inflation—using specified indexes—and other factors (such as the cost of

annualizing adjustments to federal pay). If the current year's discretionary budget authority includes funds provided through supplemental appropriations, those funds are also adjusted for inflation and assumed to continue throughout the baseline period. As explained above, that rule—coupled with the timing of supplemental appropriations for operations in Iraq and Afghanistan—is a major source of the differences between CBO's current and previous baseline projections.

Uncertainty and Budget Projections

Actual budgetary outcomes are almost certain to differ from CBO's baseline projections, both because of future legislative actions and because of unanticipated changes in economic conditions and in other factors that affect federal programs and revenue sources.

The Budgetary Effects of Some Alternative Policies

To illustrate the potential effects of different fiscal policies on the baseline, CBO has estimated the budgetary impact of some alternative scenarios (see Table 1-3). The discussion below focuses on those scenarios' direct effects on revenues and outlays. However, their full impact would

6. Some exceptions exist under the Deficit Control Act. For example, spending programs that are set to expire must be assumed to continue if they have outlays of more than \$50 million in the current year and were established on or before the enactment of the Balanced Budget Act of 1997. (Programs established after that are not automatically assumed to continue.) Similarly, expiring excise taxes that are dedicated to trust funds are assumed to be extended at the current rates. (The Deficit Control Act does not provide for the extension of other expiring tax provisions, even if they have routinely been extended in the past.)

Box 1-1.**Continued****Appropriations Provided for Military Operations in Support of the Global War on Terrorism**

Public Law	Title	Budget Authority (Billions of dollars)				
		2001	2002	2003	2004	Total
107-38 (Sept. 2001)	2001 Emergency Supplemental Appropriations Act for Recovery from and Response to Terrorist Attacks on the United States	13.6				
107-117 (Jan. 2002)	Department of Defense and Emergency Supplemental Appropriations for Recovery from and Response to Terrorist Attacks on the United States Act, 2002		3.4			
107-206 (Aug. 2002)	2002 Supplemental Appropriations Act for Further Recovery from and Response to Terrorist Attacks on the United States		13.8			
107-248 (Oct. 2002)	Department of Defense Appropriations Act, 2003			6.4 ^a		
108-7 (Feb. 2003)	Consolidated Appropriations Resolution, 2003			10.0		
108-11 (April 2003)	Emergency Wartime Supplemental Appropriations Act, 2003			62.2		
108-87 (Sept. 2003)	Department of Defense Appropriations Act, 2004				-3.5 ^b	
108-106 (Nov. 2003)	Emergency Supplemental Appropriations Act for Defense and for the Reconstruction of Iraq and Afghanistan, 2004				64.8	
108-287 (Aug. 2004)	Department of Defense Appropriations Act, 2005				26.8 ^c	
Total		13.6	17.2	78.6	88.1	197.4

Source: Congressional Budget Office.

Note: The numbers in this table are amounts identified in appropriation acts as funding for Department of Defense activities in response to the terrorist attacks on September 11, 2001, and in support of the global war on terrorism, including military operations in Afghanistan and Iraq. They do not include funds for reconstruction activities in Iraq. (P.L. 108-11 provided \$2.5 billion for that purpose, and P.L. 108-106 provided another \$18.4 billion.) The amounts shown here represent funding directed to the Department of Defense (subfunction 051 of the federal budget).

- This figure is an estimate based on conference report language for P.L. 107-248.
- Rescission of funds appropriated in P.L. 108-11.
- Of this amount, \$25 billion is funding requested by the President for 2005 that will largely be used to cover costs incurred in that year, and \$1.8 billion is funding restored from the repeal of a previous rescission. The Congress appropriated the funds in 2004 and made them available upon enactment, so the appropriation is counted as budget authority in 2004. As of September 2004, \$1.9 billion of it had been obligated.

Table 1-3.**The Budgetary Effects of Selected Policy Alternatives Not Included in CBO's Baseline**

(Billions of dollars)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	Total, 2006- 2010	Total, 2006- 2015
Policy Alternatives That Affect Discretionary Spending													
Assume Phasedown of Activities in Iraq and Afghanistan and Continued Spending for the Global War on Terrorism ^a													
Effect on the deficit	-30	-70	-75	-65	-45	-30	-25	-26	-27	-27	-28	-285	-418
Debt service	*	-3	-7	-11	-14	-17	-19	-22	-24	-27	-29	-51	-172
Increase Total Discretionary Appropriations at the Growth Rate of Nominal GDP													
Effect on the deficit	0	-15	-40	-68	-97	-126	-156	-186	-217	-249	-283	-347	-1,437
Debt service	0	*	-2	-5	-9	-15	-23	-33	-45	-59	-76	-31	-268
Freeze Total Discretionary Appropriations at the Level Provided for 2005													
Effect on the deficit	0	14	32	52	74	97	121	144	169	195	221	269	1,118
Debt service	0	*	1	4	7	12	18	26	35	46	59	25	208
Policy Alternatives That Affect the Tax Code													
Extend Expiring Tax Provisions ^b													
Effect on the deficit													
EGTRRA and JGTRRA	0	-3	-4	-11	-23	-19	-160	-259	-269	-281	-292	-60	-1,321
Other	*	-2	-11	-19	-22	-28	-34	-39	-43	-46	-50	-83	-295
Total	*	-5	-16	-30	-45	-47	-194	-298	-312	-327	-342	-143	-1,616
Debt service	*	*	-1	-2	-4	-6	-13	-26	-43	-61	-82	-13	-238
Reform the Alternative Minimum Tax ^c													
Effect on the deficit	0	-12	-34	-41	-50	-60	-50	-27	-33	-40	-47	-198	-395
Debt service	0	*	-1	-3	-6	-9	-12	-15	-17	-20	-23	-20	-108
Memorandum:													
Total Deficit (-) or Surplus in CBO's Baseline	-368	-295	-261	-235	-207	-189	-80	71	85	115	141	-1,188	-855

Sources: Congressional Budget Office; Joint Committee on Taxation.

Notes: EGTRRA = Economic Growth and Tax Relief Reconciliation Act of 2001; JGTRRA = Jobs and Growth Tax Relief Reconciliation Act of 2003; * = between -\$500 million and \$500 million.

Positive amounts indicate a reduction in the deficit or an increase in the surplus. "Debt service" refers to changes in interest payments on federal debt resulting from changes in the government's borrowing needs.

- This alternative assumes an eventual slowdown of U.S. activities in Iraq and Afghanistan but continued spending for the global war on terrorism throughout the 10-year period. It also includes funding for domestic military operations for homeland security.
- This estimate does not include the effects of extending the increased exemption amount for the alternative minimum tax, which expires in December 2005. The effects of that alternative are shown below.
- This alternative assumes that the exemption amount for the AMT (which was increased through December 2005 in the Working Families Tax Relief Act of 2004) is extended at its higher level and, together with the AMT tax brackets, is indexed for inflation after 2005. The estimates are shown relative to current law. If this alternative was enacted jointly with the extension of expiring tax provisions, an interactive effect would occur that would make the combined revenue loss greater than the sum of the two separate estimates by about \$247 billion (plus \$24 billion in debt-service costs) over the 2006-2015 period.

include their effect on federal debt-service costs, which is shown separately in the table.

Since military activities in Iraq and Afghanistan and other operations related to the global war on terrorism will continue in 2005 and for some unknown period thereafter, CBO has constructed a possible path of spending for such activities. It assumes that force levels and operations will remain at about the same levels in 2005 and 2006 as they did in 2004 and then will decline gradually over several years. Such a scenario might involve keeping about 200,000 active-duty, Reserve, and National Guard personnel deployed overseas to support those activities through fiscal year 2006. But over the longer term, it could involve reducing U.S. military involvement in those activities to about four brigades (40,000 troops) and decreasing domestic military operations for homeland security. Such a scenario would add about \$30 billion to baseline discretionary outlays for 2005 and \$418 billion for the 2006-2015 period.⁷ Many other outcomes—some costing more and some costing less—are also possible for such activities.

In addition, alternative assumptions could be made about discretionary spending as a whole. For example, if current appropriations were assumed to grow at the same rate as nominal GDP through 2015 instead of at the rate of inflation, total projected discretionary spending would be \$1.4 trillion higher. In the other direction, if lawmakers did not increase appropriations after 2005 to account for inflation, cumulative discretionary outlays would be \$1.1 trillion lower.

Three mandatory programs—Social Security, Medicare, and Medicaid—dominate federal spending. In 2004, outlays for those programs totaled \$965 billion (excluding offsetting receipts from Medicare premiums) and accounted for 42 percent of federal spending. Legislation could affect such large programs in significant ways. For example, the Administration is considering broad changes to the Social Security program, including allowing workers to divert part of their tax payments into private investments. No details are yet available, but such a plan could affect budgetary totals during the baseline period and well beyond. Likewise, changes in the laws that set payment rates, eligibility, and other criteria for Medi-

care and Medicaid are proposed and considered every year. For example, for each year since 2003, Medicare's payment rates for physicians' services (which are set by a procedure known as the sustainable growth rate formula) have been raised above the levels previously set by law. Further actions of that kind would lift outlays for Medicare considerably above baseline levels over the coming 10 years.

For revenues, CBO's baseline projections rest on the assumption that current tax laws do not change. For example, the baseline envisions that major provisions of EGTRRA—such as the introduction of the 10 percent tax bracket, increases in the child tax credit, and the repeal of the estate tax—will expire as scheduled at the end of 2010. On balance, the tax provisions that are set to expire during the projection period reduce revenues; thus, if they were assumed to be extended, projected revenues would be lower than the level in the baseline.⁸ For example, if all expiring tax provisions (except those related to the exemption amount for the alternative minimum tax, or AMT) were extended, total revenues over the 2006-2015 period would be \$1.6 trillion lower.⁹

Another policy change that could affect revenues involves modifying the AMT, which many observers believe cannot be maintained in its current form. The AMT's exemption amount and brackets are not indexed for inflation, which means that the impact of the tax will grow in coming years as more taxpayers become subject to it. If the AMT was indexed for inflation after 2005, federal revenues would be \$395 billion lower over the next 10 years, according to CBO and the Joint Committee on Taxation.

Other Sources of Uncertainty

Aside from the impact of future legislative actions, the federal budget is also sensitive to economic and technical factors that are difficult to forecast. In creating its baseline, CBO must make assumptions about such economic factors as interest rates, inflation, and the growth of GDP.

7. The scenario assumes that the military services would need to replace equipment that was destroyed, damaged, or worn out in those operations.

8. In the years before 2011, the largest contributors to the cost of extending those provisions are the research and experimentation tax credit and the reduced tax rates on dividends and capital gains.

9. Unlike CBO's baseline projections, which incorporate the effects that the expiration of tax provisions would have on the economy, that estimate does not include any macroeconomic effects. Such effects are likely to be small relative to the overall economy.

(CBO's economic assumptions are explained in detail in Chapter 2.) Discrepancies between those assumptions and actual economic conditions can have a significant impact on the extent to which budgetary outcomes differ from baseline projections. For instance, the baseline reflects an assumption that the real (inflation-adjusted) growth rate of GDP will slowly fall from 3.8 percent in calendar year 2005 to 2.5 percent in 2015. If the actual growth rate of GDP was 0.1 percent higher or lower per year, the cumulative deficit for the 2006-2015 period would differ from CBO's projections by about \$260 billion. (For a further discussion of the effect of economic assumptions on budget projections, see Appendix A.)

Uncertainty also exists about technical factors—those not directly related to changes in law or in CBO's economic forecast—that affect budget projections. For example, spending per enrollee for both Medicare and Medicaid has been growing faster than per capita GDP. The future level of such “excess cost growth” is difficult to forecast, but it will have a large impact on the costs of those programs. In addition, projections of those costs depend on assumptions about the growth of enrollment in the programs and, indirectly, about general inflation. Similarly, CBO must estimate prices for various agricultural commodities as well as crop yields, all of which are volatile and significantly affect how much the government will pay farmers under price- and income-support programs.

Revenue projections too are vulnerable to technical uncertainty. Although the overall level of income is determined by economic projections, CBO must make technical assumptions about how much revenue to expect from a given amount of income. Differences between expected and actual revenue yields can lead to significant deviations from CBO's baseline projections.

Using the difference between past CBO baselines and actual budgetary results as a guide, Figure 1-3 displays a range of possible outcomes for the total deficit or surplus under current law (excluding the possible impact of future legislation). The current baseline projection of the deficit falls in the middle of the highest-probability area, shown as the darkest part of the figure. But nearby projections—other paths in the darkest part of the figure—have nearly the same probability of occurring that the baseline projection does. Projections that are increasingly different from the baseline are shown in lighter areas, but they also have a significant probability of coming to pass. For example, CBO projects a baseline deficit of 1.2 per-

cent of GDP for 2010. However, under current law, there is roughly a 5 percent chance that the actual outcome that year will be a deficit greater than 6 percent of GDP. Similarly, in the absence of further legislative changes, there is a 35 percent chance that the budget will be in balance or surplus in 2010.

The Long-Term Outlook

In the decades beyond CBO's projection period, the aging of the baby-boom generation, combined with rising health care costs, will cause a historic shift in the United States' fiscal situation. Over the next 30 years, the number of people age 65 or older will double, while the number of adults under age 65 will increase by less than 15 percent.¹⁰ Moreover, health care costs are likely to continue to grow faster than the economy. (Between 1960 and 2001, the average annual growth rate of national health expenditures exceeded the growth rate of GDP by 2.5 percentage points.)

Driven by rising health care costs, spending for Medicare and Medicaid is increasing faster than can be explained by the growth of enrollment and general inflation alone. If excess cost growth continued to average 2.5 percentage points in the future, federal spending for Medicare and Medicaid would rise from 4.2 percent of GDP today to about 11.5 percent of GDP in 2030 (see Figure 1-4). The Medicare trustees assume that excess cost growth will decline to 1 percentage point, on average; however, even at that rate, federal spending for Medicare and Medicaid would double to 8.4 percent of GDP by 2030.¹¹

Outlays for Social Security as a share of GDP are projected to grow by more than 40 percent in the next three decades under current law: from about 4.2 percent of GDP to more than 6 percent. Such costs are likely to creep up gradually thereafter. By contrast, federal revenues credited to Social Security are expected to remain close to their current level—around 5 percent of GDP—over that period.

Together, the growing resource demands of Social Security, Medicare, and Medicaid will exert pressure on the

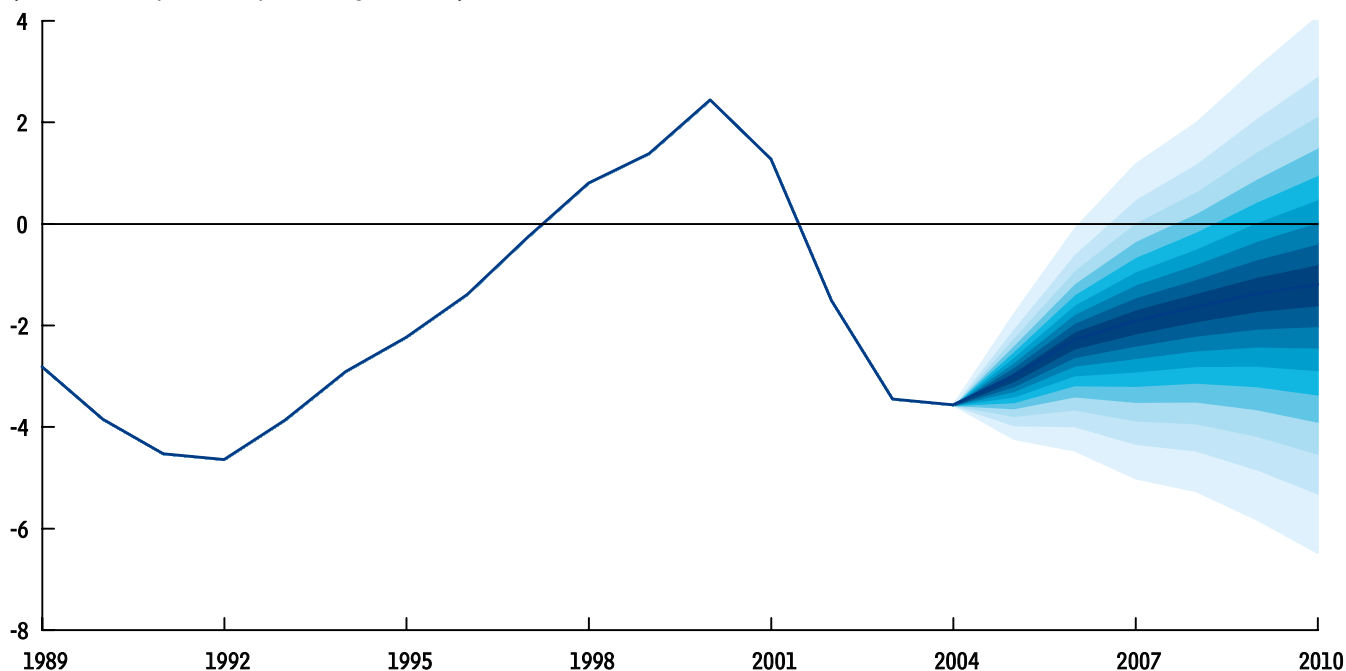
10. For a more extensive discussion, see CBO, *The Long-Term Budget Outlook* and *The Outlook for Social Security*.

11. See Technical Review Panel on the Medicare Trustees Reports, *Review of Assumptions and Methods of the Medicare Trustees' Financial Projections* (December 2000).

Figure 1-3.

Uncertainty of CBO's Projections of the Budget Deficit or Surplus Under Current Policies

(Deficit or surplus as a percentage of GDP)



Source: Congressional Budget Office.

Notes: This figure, calculated on the basis of CBO's forecasting track record, shows the estimated likelihood of alternative projections of the budget deficit or surplus under current policies. The baseline projections described in this chapter fall in the middle of the darkest area of the figure. Under the assumption that tax and spending policies will not change, the probability is 10 percent that actual deficits or surpluses will fall in the darkest area and 90 percent that they will fall within the whole shaded area.

Actual deficits or surpluses will be affected by legislation enacted in future years, including decisions about discretionary spending. The effects of future legislation are not reflected in this figure.

For an explanation of how CBO typically calculates the probability distribution underlying figures such as this one, see Congressional Budget Office, *The Uncertainty of Budget Projections: A Discussion of Data and Methods* (April 2004).

budget that economic growth alone is unlikely to alleviate. Consequently, policymakers face choices that involve reducing the growth of federal spending, increasing taxation, boosting federal borrowing, or some combination of those approaches.

Changes to the Budget Outlook Since September 2004

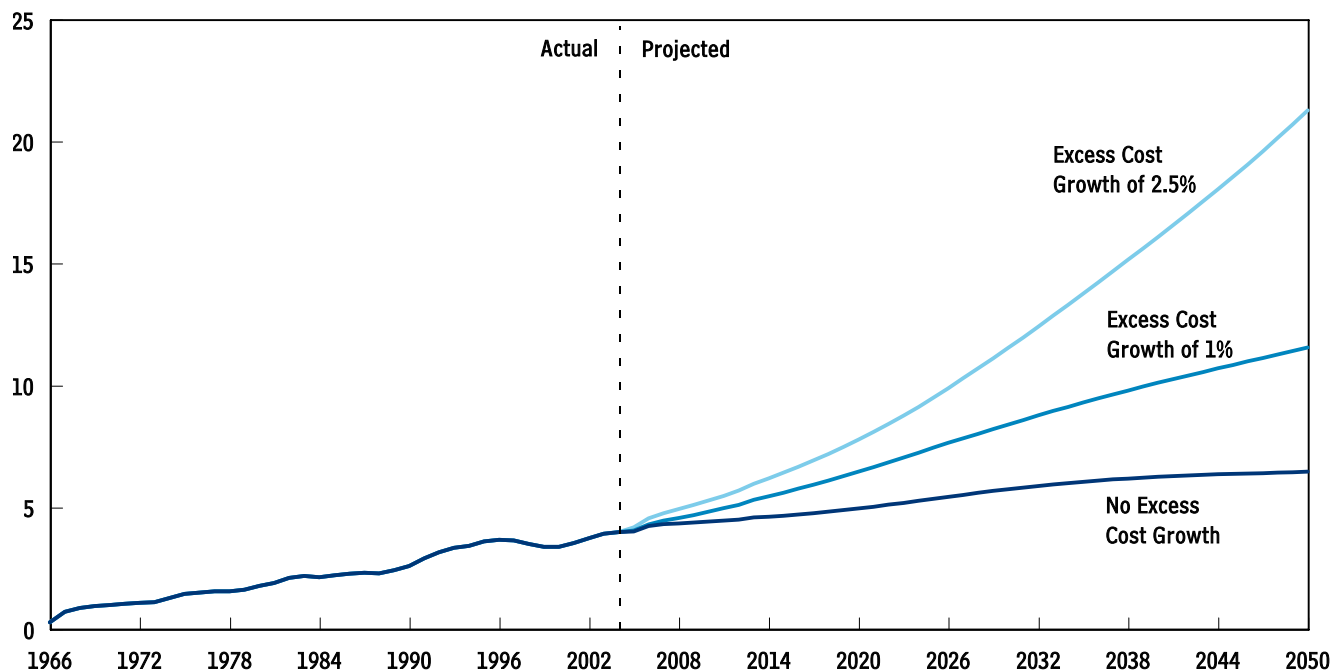
CBO's projection of the cumulative deficit for the 2005-2014 period has declined by \$930 billion since last September, when the agency published its previous baseline. But that figure gives a misleading picture of changes to the underlying budget outlook. As illustrated in Table 1-1

on page 2, the apparent improvement in the projected 10-year deficit derives largely from the treatment of spending for operations in Iraq and Afghanistan. Because the statutes that govern the baseline require that all discretionary budget authority for the most recent year be extrapolated through the projection period, CBO's September baseline contained about \$1.4 trillion in outlays (including debt-service costs) that are not in the current baseline, since no supplemental funding for Iraq and Afghanistan has yet been provided for 2005. Revisions to the baseline that are unrelated to the treatment of such funding partially offset that change, increasing projected deficits over the 2005-2014 period by more than \$500 billion.

Figure 1-4.

Total Federal Spending for Medicare and Medicaid Under Different Assumptions About Excess Cost Growth

(Percentage of GDP)



Source: Congressional Budget Office.

Note: "Excess cost growth" refers to the degree to which the annual growth rate of federal spending for Medicare and Medicaid exceeds the annual rate of gross domestic product.

When CBO revises its baseline projections, it divides the changes into three categories according to their cause: recently enacted legislation, changes to CBO's outlook for the economy, and technical factors that affect the budget.¹² Legislative changes have reduced the 10-year deficit by more than \$1 trillion, primarily because of the treatment of supplemental funding for military operations. Changes to economic and technical assumptions have had a relatively small effect on the projections, combining

to boost the cumulative deficit by \$132 billion (less than 0.1 percent of GDP).

Outlay projections have declined by \$17 billion for this year and by a total of \$1.1 trillion (including debt-service costs) for the 2005-2014 period (see Table 1-4 on page 14). Removal from the baseline of the extrapolated \$115 billion in supplemental appropriations enacted in 2004, which CBO categorizes as a legislative change, accounts for most of that decline. Changes in CBO's economic assumptions (particularly about inflation) and various technical changes have had a minor offsetting effect on projected outlays, increasing them by a total of \$52 billion over 10 years.

CBO's revenue projections have declined by \$37 billion for 2005 and by \$209 billion for the 2005-2014 period. Together, laws enacted since September and technical changes have reduced projected revenues over the 10-year period by \$281 billion, whereas revisions to economic

12. The categorization of revisions should be interpreted with caution. For example, legislative changes represent CBO's best estimates of the future effects of laws enacted since the previous baseline. If a new law proves to have different effects from the ones in CBO's initial estimate, the differences will appear as technical reestimates in later revisions to the baseline. The distinction between economic and technical revisions is similarly imprecise. CBO classifies economic changes as those resulting directly from changes in the components of CBO's economic forecast (interest rates, inflation, GDP growth, and so on). Changes in other factors related to the performance of the economy (such as the amount of capital gains realizations) are shown as technical reestimates.

assumptions have increased projected revenues by \$72 billion.

The Effects of Recent Legislation

Legislative changes to CBO's baseline since last September have increased this year's projected deficit by \$6 billion but lowered the cumulative deficit through 2014 by more than \$1 trillion. As noted above, most of that change results from differences in the treatment of spending for operations in Iraq and Afghanistan. In addition, laws enacted in the past five months have raised projected outlays by \$242 billion and reduced projected revenues by \$129 billion through 2014.

Mandatory Spending. Legislative changes since September have had little effect on the outlook for mandatory programs. Projected outlays for those programs have risen by \$5 billion (excluding debt-service costs) for 2005, by \$9 billion for 2006, and by a total of \$12 billion for the 2005-2014 period.

One of the largest legislative changes to mandatory spending comes from the Ronald W. Reagan National Defense Authorization Act for Fiscal Year 2005 (Public Law 108-375). That law prohibits the Air Force from leasing any tanker aircraft and repeals the authority that would have allowed the service to sign a contract to acquire 100 KC-767 tankers without regard to whether sufficient funds were available to pay the full costs of the contract. Because P.L. 108-375 prevents the Air Force from leasing or purchasing tankers without having an appropriation for the full cost of those aircraft, CBO estimates that the law will reduce mandatory spending for KC-767s by \$18.5 billion over the 2005-2014 period relative to CBO's September baseline.

P.L. 108-375 also includes provisions that affect outlays for military retirement. On net, CBO estimates that those provisions will increase mandatory spending for military retirement over the 2005-2014 period by about \$8 billion. Most of that increase comes from revisions to the survivor benefit plan (SBP) that phase out, over three-and-a-half years, the reduction in the SBP annuity that occurs when survivors become eligible for Social Security survivor benefits at age 62. The law also eliminates the 10-year phase-in for concurrent receipt of military retirement and veterans' disability compensation for retirees who are rated by the Department of Veterans Affairs as 100 percent disabled—a change that is projected to increase spending by nearly \$1 billion through 2014.

The Military Construction Appropriations and Emergency Hurricane Supplemental Appropriations Act, 2005 (P.L. 108-324) is projected to add \$2.6 billion to mandatory spending this year. That law provides emergency assistance to farmers who lost crops or livestock because of damaging weather.

The tobacco buyout provisions in the American Jobs Creation Act of 2004 (P.L. 108-357) will add an estimated \$1.5 billion to spending in 2005 and roughly \$1 billion each year from 2006 through 2014. That law also extends customs user fees through September 30, 2014—creating more than \$20 billion in additional offsetting receipts (negative spending) over the 2005-2014 period.

The Working Families Tax Relief Act of 2004 (P.L. 108-311) contains several provisions that affect refundable tax credits. Most important, WFTRA raises the child tax credit to \$1,000 through 2009. (It also increased the refundability of the credit in 2004.) Such changes are projected to add about \$2 billion to outlays this year and nearly \$24 billion over the 2005-2014 period.

The Commercial Spectrum Enhancement Act (P.L. 108-494) affects the timing of certain Federal Communications Commission (FCC) auctions of licenses to use the electromagnetic spectrum. It also creates new direct spending authority for agencies that currently use the frequencies due to be auctioned. The law sets an 18-month waiting period before the start of those auctions, which will delay the collection of \$5 billion in receipts relative to CBO's previous baseline projections but will have no net effect on the budget over time. After purchasers pay for the licenses—which is now expected to occur in 2007 and 2008—the proceeds will be available to agencies without further appropriation to pay for any costs incurred to relocate federal services to other frequencies. CBO estimates that agencies will spend about \$2.5 billion over the 2007-2014 period for those costs.

Finally, various smaller legislative changes to mandatory programs are projected to boost spending by about \$5 billion over 10 years.

Discretionary Spending. Since September, CBO's baseline projections of discretionary spending have declined by \$31 billion for 2005 and by more than \$1 trillion for the 2005-2014 period because of revisions attributable to legislation.

Table 1-4.**Changes in CBO's Baseline Projections of the Deficit Since September 2004**

(Billions of dollars)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Total, 2005- 2009	Total, 2005- 2014
Total Deficit as Projected in September 2004	-348	-298	-308	-318	-312	-298	-200	-70	-75	-65	-1,584	-2,294
Changes to Revenue Projections												
Legislative	-32	-46	-25	-14	-6	-6	*	1	*	-1	-122	-129
Economic	-14	-25	-23	-9	3	14	18	28	37	43	-68	72
Technical	9	4	-2	-1	-8	-22	-33	-33	-34	-33	3	-152
Total Revenue Changes	-37	-67	-49	-23	-11	-15	-15	-5	3	10	-187	-209
Changes to Outlay Projections												
Legislative												
Discretionary												
Defense	-33	-76	-89	-93	-95	-97	-100	-101	-104	-106	-386	-895
Nondefense	1	-6	-12	-14	-15	-15	-15	-15	-14	-14	-46	-119
Subtotal, discretionary	-31	-82	-101	-107	-110	-112	-115	-116	-119	-121	-432	-1,014
Mandatory	5	9	1	1	3	2	-2	-2	-2	-2	19	12
Net interest (Debt service)	*	*	-3	-7	-13	-19	-25	-33	-40	-49	-23	-189
Subtotal, legislative	-26	-74	-103	-114	-119	-130	-142	-151	-161	-171	-436	-1,191
Economic												
Discretionary	0	2	2	2	2	2	2	2	2	1	8	18
Mandatory	-1	4	5	2	9	-1	1	*	-1	-11	20	8
Net interest												
Debt service	*	1	3	4	4	4	4	3	2	-1	12	24
Rate effect/inflation	-1	-4	-4	-3	-2	-2	-1	-1	-1	-1	-14	-18
Subtotal, net interest	-1	-3	-1	1	2	3	3	2	1	-1	-2	5
Subtotal, economic	-3	3	6	6	13	4	6	4	2	-11	26	31

Continued

As noted above, no supplemental funding for activities in Iraq and Afghanistan has yet been provided in 2005 (the current base year used to project discretionary spending), although about \$115 billion was provided in 2004 (the base year for the September projections). Because of that difference, CBO has had to decrease its projections of discretionary spending relative to the September baseline by \$38 billion for 2005 and by more than \$1.1 trillion (not including associated debt-service costs) through 2014.

Increases in other appropriations have offset that decrease slightly. The 2005 Military Construction Appropriations and Emergency Hurricane Supplemental Appropriations Act provides \$11.5 billion in supplemental appropria-

tions for relief from natural disasters and other purposes. Extrapolating that budget authority through 2014 adds \$94 billion in outlays to the baseline. Also, \$2 billion in supplemental funding for disaster relief was provided in September (after CBO's baseline had been completed); those outlays are anticipated to occur during the 2005-2008 period.

In addition, regular appropriations for 2005 for agencies other than the Department of Defense are slightly higher, overall, than the amounts assumed in the September baseline. Although funding has risen for most areas of the budget, the largest increases are in the general categories of transportation, federal law enforcement, and veterans'

Table 1-4.**Continued**

(Billions of dollars)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Total, 2005- 2009	Total, 2005- 2014
Changes to Outlay Projections (Cont'd)												
Technical												
Discretionary	-3	-6	-2	*	-2	-3	-4	-5	-5	-5	-13	-34
Mandatory												
Medicaid	3	4	4	4	4	4	4	3	2	1	19	33
Food Stamps	3	3	3	3	3	3	3	3	3	3	15	30
Unemployment Insurance	-4	-5	-3	-3	-3	-3	-2	-2	-1	*	-19	-26
Farm programs (CCC)	8	6	3	*	-1	-1	-1	-2	-2	-1	15	8
Credit reestimates	7	0	0	0	0	0	0	0	0	0	7	7
Other	-2	-2	-2	*	-8	3	*	-3	-4	4	-14	-14
Subtotal, mandatory	14	7	5	4	-6	6	3	*	-1	7	25	39
Net interest												
Debt service	*	-1	-1	-1	*	*	2	3	5	7	-2	16
Other	1	-1	-2	-1	-2	-1	*	1	2	2	-4	1
Subtotal, net interest	1	-1	-2	-1	-2	-1	2	5	7	10	-6	16
Subtotal, technical	11	*	1	2	-10	2	1	*	1	11	5	21
Total Outlay Changes	-17	-70	-96	-106	-116	-124	-135	-146	-158	-171	-405	-1,139
Total Impact on the Deficit	-20	4	47	83	104	109	120	142	161	180	218	930
Total Deficit (-) or Surplus as Projected in January 2005	-368	-295	-261	-235	-207	-189	-80	71	85	115	-1,366	-1,364
Memorandum:												
Total Legislative Changes	-6	28	79	100	113	123	142	151	161	170	314	1,062
Total Economic Changes	-11	-28	-29	-15	-10	10	12	24	35	54	-94	41
Total Technical Changes	-2	4	-3	-3	1	-24	-34	-33	-35	-44	-2	-173

Source: Congressional Budget Office.

Note: * = between -\$500 million and \$500 million; CCC = Commodity Credit Corporation.

health care. Extrapolating all of the changes in 2005 regular appropriations through 2014 raises projected outlays by a total of \$32 billion over the 10-year period.

Revenues. Legislative changes have reduced projected receipts by \$129 billion over the 2005-2014 period, with virtually all of that reduction occurring before 2011. By far the most significant change—accounting for \$122 billion of the reduction—results from the enactment of WFTRA, which extends a number of expiring provisions first enacted in the Economic Growth and Tax Relief Reconciliation Act and then modified in the Jobs and Growth Tax Relief Reconciliation Act. Under EGTRRA,

the amounts of the increased child credit, the expanded 10 percent tax bracket, and marriage-penalty relief had been set to phase in over time; JGTRRA accelerated that timing so all of the amounts were fully phased in by 2004, but only for that year. WFTRA maintains those amounts at their fully phased-in levels through 2010, after which all of the provisions enacted in EGTRRA are due to expire. The decline in revenues from that change is concentrated in the next few years, before the higher amounts would have been fully phased in under prior law. Other changes in WFTRA also contribute to reducing revenues early in the projection period. The law extends through 2005 the higher exemption amount for the

alternative minimum tax as well as a number of tax provisions (such as the research and experimentation credit) that had regularly been extended temporarily over the years but had already expired.

In addition, the recently enacted American Jobs Creation Act makes numerous changes to tax law, such as replacing an exclusion of income earned by exporters with a deduction of income from domestic production. That law has reduced projected revenues by a total of \$7 billion through 2014.

Net Interest. Together, revisions to the September baseline that are classified as legislative decrease the cumulative deficit for the 2005-2014 period by \$873 billion (excluding debt service). In turn, that reduction in the need to borrow is projected to lessen the government's debt-service costs through 2014 by a total of \$189 billion. As a result, legislative revisions reduce the projected cumulative deficit by more than \$1 trillion in all.

The Effects of Economic Changes

Updates to CBO's economic assumptions since September have had a relatively minor effect on the budget outlook. Such changes increase this year's projected deficit by \$11 billion (almost entirely on the revenue side of the budget) but decrease the total deficit projected for the 2005-2014 period by \$41 billion (through raising projected revenues by \$72 billion and projected outlays by \$31 billion). CBO is now forecasting slightly lower levels of nominal GDP and wages in the next few years, and slightly higher levels in later years, than it did last September (see Chapter 2), which reduces estimated revenues in the near term and raises them thereafter. In addition, CBO's new forecast envisions a higher rate of inflation this year and a slightly lower rate next year than the previous forecast did.

Mandatory Spending. Food Stamps, Medicaid, and Social Security are the three mandatory programs most affected by changes to the economic forecast. Those changes have increased projections of mandatory spending by \$20 billion for 2005 through 2009 and lowered them by about \$12 billion for the following five years—on net, adding \$8 billion to projected mandatory outlays for the 2005-2014 period.

Since September, CBO has raised its near-term forecast of the consumer price index for the cost of food purchased for consumption at home. As a result, average Food

Stamp benefits are projected to increase, boosting outlays for the program by \$12 billion over 10 years.

In the Medicaid program, payment rates for services are generally not linked to specific price factors. Nevertheless, CBO anticipates that changes in its economic outlook will affect spending for the program. In particular, the decline in projected medical inflation will reduce Medicaid spending for hospital and physicians' services, CBO projects. To a lesser extent, lower projected wage growth will reduce spending for long-term care, which is influenced by labor costs. Because of those changes to the economic forecast, CBO currently estimates that federal Medicaid spending will be \$8 billion lower over the next 10 years than previously projected.

The cost-of-living adjustment (COLA) that Social Security beneficiaries will receive in January 2006 is now expected to be 0.5 percentage points higher than CBO projected in September, increasing benefit payments in 2006 and beyond. Changes to projections of nominal wages also affect Social Security spending by changing projections of initial benefits for new recipients. In all, such economic revisions increase projected Social Security spending over the 2005-2014 period by \$5 billion.

The COLA reestimate also produces a small increase in projected spending for other programs, including civil service retirement, military retirement, Supplemental Security Income, and some veterans' benefits.

Discretionary Spending. As explained above, most of the revisions to projections of discretionary spending result from legislative changes. But changes in CBO's assumptions about two measures of inflation—the GDP price deflator (which covers the changes in prices of all goods and services that contribute to GDP) and the employment cost index for wages and salaries—cause a small net increase (\$18 billion) in projected discretionary spending through 2014.

Revenues. Changes in CBO's economic outlook have had a relatively minor effect on revenue projections, lowering them through 2008 and raising them thereafter—for a net increase of \$72 billion over the 2005-2014 period. CBO has reduced its forecasts of the growth of GDP and personal income for this year and raised them for later years. By 2007, personal income is projected to exceed the amount projected in September. That pattern reduces projected receipts from individual income and payroll

taxes through 2006 and boosts them thereafter. CBO is also anticipating lower corporate profits throughout the projection period than it did last September, which reduces projected receipts from corporate income taxes, mostly in the near term.

Net Interest. Economic revisions to projected spending for net interest have two components: the effects of changes in projected interest rates and inflation and the effects of additional (or reduced) debt service. In the current economic forecast, interest rates on 10-year Treasury notes are about half a percentage point lower in 2005 and marginally lower in 2006 than previously anticipated. However, savings from those lower long-term rates are partially offset by increased outlays resulting from higher projections of short-term rates in those two years. Overall, such changes in CBO's economic forecast reduce projected outlays for net interest by \$18 billion over 10 years.

In addition, changes in the economic outlook increase projected deficits between 2005 and 2009, adding a total of \$12 billion to debt-service costs during those years. The growth of such costs reverses later in the projection period: economic revisions lower projected deficits, causing additional debt-service charges to decline each year (from a cost of \$4 billion in 2010 to a savings of less than \$1 billion in 2014).

The Effects of Technical Changes

Technical changes represent all other revisions to the baseline not directly related to recent laws or to changes in the components of CBO's economic forecast. Over the 2005-2014 period, technical revisions increase the cumulative deficit by \$173 billion, mainly by reducing projected revenues.

Mandatory Spending. Because of technical adjustments, CBO is projecting an additional \$14 billion in mandatory spending this year and \$39 billion (or 0.2 percent) over the 2005-2014 period relative to the previous baseline. Most of the increase results from higher projected spending for the Medicaid and Food Stamp programs, partly offset by reductions in projected unemployment insurance payments.

A variety of technical revisions have added \$33 billion (or 1.3 percent) to CBO's projection of federal spending for Medicaid over 10 years. Those revisions reflect the fact that Medicaid spending in 2004 was higher than anticipated and that the number of people expected to enroll in

the program has increased. The impact of those changes on spending is largely offset by lower estimates of growth in per capita spending.

Projected outlays for the Food Stamp program over the 2005-2014 period have grown by \$30 billion since the September baseline because CBO's estimate of participation in the program has increased. Rates of participation have persistently been higher than expected for the past few years, despite falling unemployment rates. The magnitude of the increase has led CBO to conclude that there is a slightly longer lag between declines in the unemployment rate and declines in Food Stamp participation than previously believed. In addition, legislative changes to the program in recent years have led to an increase in outreach efforts, an expansion of eligibility, and some simplification of the application process. For all of those reasons, more people appear to be applying for benefits than was the case in the past.

Outlays for unemployment compensation over the 10-year projection period are \$26 billion lower in the current baseline than in the previous baseline. More than half of that change comes from a reduction in the number of people expected to claim benefits (based on recent and historical rates of insured unemployment). About 8.7 million people received unemployment compensation in 2004; CBO expects that number to decline to about 8.4 million this year. In addition, about 40 percent of the change in estimated outlays is attributable to lower projected average benefits. States are responsible for setting the parameters under which people can claim benefits, with maximum amounts generally tied to some measure of average wages. The average benefit in 2004 grew little from the previous year, thus creating a lower base for projecting benefits for coming years.

Prices of some major agricultural commodities—especially feed grains, cotton, and soybeans—have experienced sharp declines. That and other factors have led CBO to raise its estimates of spending by the Commodity Credit Corporation (CCC) for farm price-support and income-support payments in 2005 through 2007 by a total of \$17 billion. Projections of CCC spending in later years have declined slightly, for a net increase of \$8 billion over the 2005-2014 period.

CBO's projection of mandatory spending in 2005 reflects another technical change: a net increase in the estimated subsidy cost for a number of federal programs that make

loans directly to individuals or businesses or that guarantee loans made by private financial institutions. The budget records the cost of such credit programs as the projected net present value of government losses on outstanding loans and guarantees. Accurately projecting loan repayments, defaults, and changes in interest rates over the life of a credit program is difficult, however. As a result, federal agencies annually revise their estimates of costs for loans and guarantees made in previous years. On the basis of preliminary information from the Administration, CBO has raised its estimate of mandatory outlays in 2005 by \$7 billion to reflect such revisions. The reestimates affect a variety of programs, including the Federal Housing Administration's Mutual Mortgage Insurance program, the FCC's spectrum auctions, the Small Business Administration's business loan programs, and federal student loan programs.

Discretionary Spending. Technical revisions to the baseline have reduced projections of discretionary outlays by \$3 billion for 2005 and by a total of \$34 billion (or 0.3 percent) for the 2005-2014 period. Those revisions affect nearly all areas of the budget, but the largest change involves the program that provides housing vouchers for low-income renters. CBO has adopted a new estimating method that will better align the baseline for that program with the intent of the Deficit Control Act and will treat the program's accounts in the same way as other discretionary accounts. The Deficit Control Act's procedure for producing a baseline for that program reflects the fact that when the law was enacted, the voucher program featured many multiyear contracts, which received all of their funding at the beginning of the contract period. That is no longer the case; today, most contracts are for only one year. As a result, CBO now projects budget authority for the voucher program the same way that it does for most other discretionary programs (by inflating the current year's budget authority) and then includes an add-on for expiring multiyear contracts. That new approach reduces projected outlays for the program by \$24 billion over 10 years.

Revenues. CBO has lowered its revenue projections for the 2005-2014 period by \$152 billion as a result of technical changes. Most of those changes apply to receipts from individual income taxes and occur in the second half of the projection period (totaling \$155 billion between 2010 and 2014). Technical changes are quite small for 2005 through 2009.

The main changes in the later years of the projection derive from two sources: information that is now available from 2002 tax returns, and new estimates of the effects of asset accumulations in tax-deferred retirement accounts, such as individual retirement accounts and 401(k) accounts. Tax returns for 2002 show lower amounts of taxable income than CBO anticipated, and CBO expects that the causes of that shortfall will continue through the later years of the projection period, thereby reducing receipts. In addition, new estimates of activity in retirement accounts indicate that accrual of dividend and interest income in taxable accounts is likely to be smaller than CBO projected earlier. Those two factors also reduce revenues in the first five years of the projection, but the reduction is largely offset by a change in CBO's estimate of the effects of a cut in the tax rates on dividends (which will expire in 2009). CBO now believes that the cut will not lower revenues as much as previously thought.

Net Interest. New information about the composition and amount of federal debt and additional details about federal interest payments and receipts have led CBO to increase its projections of net interest outlays by \$1 billion (excluding debt service) over the 2005-2014 period. In addition, because technical changes to the baseline increase the cumulative deficit over that period by \$157 billion, federal debt-service costs are projected to rise by a total of \$16 billion.

The Outlook for Federal Debt

The federal government's debt falls into two main categories: debt that is held by the public (in the form of marketable and nonmarketable Treasury securities) and debt that is held by government accounts. Debt held by the public is the more meaningful measure in terms of the relationship between federal debt and the economy. It represents debt that the Department of the Treasury issues to raise cash to fund the operations and pay off the maturing liabilities of the federal government. Debt held by government accounts consists of securities that the Treasury issues to various federal agencies. Those intra-governmental IOUs are used as an accounting device to track cash flows relating to specific federal programs, such as Social Security.

Debt Held by the Public

When the federal government runs a deficit, the Treasury borrows money from the public by selling securities in the capital markets to various buyers, such as foreign in-

vestors, mutual funds, state and local governments, commercial banks, insurance companies, and individuals. Of those groups, foreign investors (governments, businesses, and individuals) are currently the largest owners of federal debt issued to the public. They hold nearly \$1.9 trillion—or more than 43 percent—of the roughly \$4.3 trillion that is now outstanding.

Among foreign countries, investors in Japan, China, and the United Kingdom have the largest holdings of Treasury securities.¹³ The central bank and private entities in Japan alone hold about \$715 billion in such securities, more than \$229 billion of which were bought in 2004—equal to roughly 55 percent of the U.S. deficit that year. In all, foreign investors purchased nearly \$399 billion in Treasury securities last year—just \$13 billion less than the size of the 2004 deficit.

State and local governments and mutual funds in the United States are also large investors in Treasury securities. Those governments hold \$368 billion in debt held by the public, and mutual funds hold \$258 billion.¹⁴

Debt held by the public fluctuates according to changes in the government's borrowing needs. It equaled nearly 50 percent of GDP in 1993 but fell to about 33 percent of GDP by 2001 (see Figure 1-2 on page 4). Over the past three years, debt held by the public has crept up to 37 percent of GDP. Under the baseline assumption that current law does not change (for example, that no further funding is provided for operations in Iraq and Afghanistan and that taxes rise as scheduled), debt held by the public is projected to peak at 39 percent of GDP in 2007 and then fall steadily to 29 percent of GDP in 2015 (see Table 1-5).

The Composition of Debt Held by the Public. Roughly 90 percent of publicly held debt consists of marketable securities—Treasury bills, notes, bonds, and inflation-indexed issues (called TIPS). The remaining 10 percent comprises nonmarketable securities, such as savings bonds and state

and local government securities, which are nonnegotiable, nontransferable debt instruments issued to specific investors.¹⁵

The Treasury sells marketable securities to brokers in regularly scheduled auctions, whose size varies along with changes in the government's cash flow. (The Treasury also sells cash-management bills periodically to cover shortfalls in cash balances.) In 2004, the Treasury changed its mix of marketable securities to meet investors' growing demand for assets that protect against inflationary risks: it introduced a 20-year TIPS bond, which is issued on a semiannual basis, and began issuing five-year TIPS notes semiannually in October. Those changes could attract new investors, and the addition of a TIPS security with a longer maturity will diversify the Treasury's portfolio. However, those changes could increase the Treasury's exposure to inflationary risks.

Why Changes in Debt Held by the Public Do Not Equal the Size of Deficits and Surpluses. In most years, the amount of debt that the Treasury borrows or redeems approximates the annual budget deficit or surplus. However, a number of factors—which are broadly labeled “other means of financing”—also affect the government's need to borrow money from the public. CBO projects that debt held by the public will increase by more than the cumulative deficit over the 2005-2015 period because changes in other means of financing will raise the Treasury's borrowing needs (see Table 1-5).

In most years, the largest of the other means of financing is the capitalization of financing accounts used for federal credit programs. Direct student loans, rural housing programs, loans by the Small Business Administration, and other credit programs require the government to disburse money up front in anticipation of repayment at a later date. Those initial outlays are not counted in the budget, which reflects only the estimated subsidy costs of such programs. From 2006 through 2015, the amount of loans being disbursed will typically be larger than the amount of repayments and interest being collected. Thus, the government's annual borrowing needs will be \$11 billion to \$15 billion greater than the annual budget deficit or surplus would indicate.

13. See Department of the Treasury, “Major Foreign Holders of Treasury Securities” (December 15, 2004), available at www.ustreas.gov/tic/mfh.txt. That information should be viewed as approximate because the Treasury's data indicate the country where a purchase was made, which is not necessarily the purchaser's home country.

14. Department of the Treasury, Financial Management Service, *Treasury Bulletin* (December 2004).

15. State and local government securities are time deposits that the Treasury sells to the issuers of state and local government tax-exempt debt to assist in the restriction of arbitrage provisions in the Internal Revenue Code.

Table 1-5.**CBO's Baseline Projections of Federal Debt**

(Billions of dollars)

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Debt Held by the Public at the Beginning of the Year	3,913	4,296	4,665	4,971	5,246	5,494	5,716	5,919	6,012	5,955	5,884	5,784
Changes to Debt Held by the Public												
Deficit or surplus (-)	412	368	295	261	235	207	189	80	-71	-85	-115	-141
Other means of financing	-30	2	11	14	13	14	14	13	14	14	15	16
Total	382	370	306	275	249	222	203	93	-58	-71	-100	-126
Debt Held by the Public at the End of the Year	4,296	4,665	4,971	5,246	5,494	5,716	5,919	6,012	5,955	5,884	5,784	5,658
Debt Held by Government Accounts												
Social Security	1,635	1,804	1,989	2,194	2,419	2,661	2,919	3,191	3,475	3,768	4,068	4,372
Other government accounts ^a	1,424	1,505	1,605	1,707	1,813	1,927	2,047	2,169	2,301	2,442	2,582	2,725
Total	3,059	3,310	3,594	3,901	4,232	4,588	4,965	5,361	5,776	6,210	6,650	7,097
Gross Federal Debt	7,355	7,975	8,565	9,146	9,726	10,304	10,884	11,373	11,731	12,094	12,434	12,755
Debt Subject to Limit ^b	7,333	7,939	8,529	9,111	9,690	10,268	10,847	11,336	11,693	12,056	12,395	12,716
Memorandum:												
Debt Held by the Public at the End of the Year as a Percentage of GDP	37.2	38.1	38.6	38.6	38.4	38.0	37.6	36.5	34.5	32.6	30.7	28.8

Source: Congressional Budget Office.

a. Mainly the Civil Service Retirement, Military Retirement, Medicare, and Unemployment Insurance Trust Funds.

b. Differs from gross federal debt primarily because it excludes most debt issued by agencies other than the Treasury. The current debt limit is \$8,184 billion.

In 2004, the relationship between the change in accumulated debt and the size of the deficit went in the other direction—debt held by the public grew by \$30 billion less than the size of the deficit. The elimination of a program that allowed the Treasury to withdraw certain nonmarketable securities (called depositary compensation securities) and interest-free loans (called compensating balances) from financial institutions that had provided services to the Treasury accounted for about \$22 billion of that difference (\$14 billion from depositary compensation securities and \$8 billion from compensating balances). The program ended after the Treasury received an appropriation in the Consolidated Appropriations Act, 2004 (P.L. 108-199) to pay those financial institutions directly. In addition, the government's borrowing requirements were lowered by \$5 billion in 2004 when

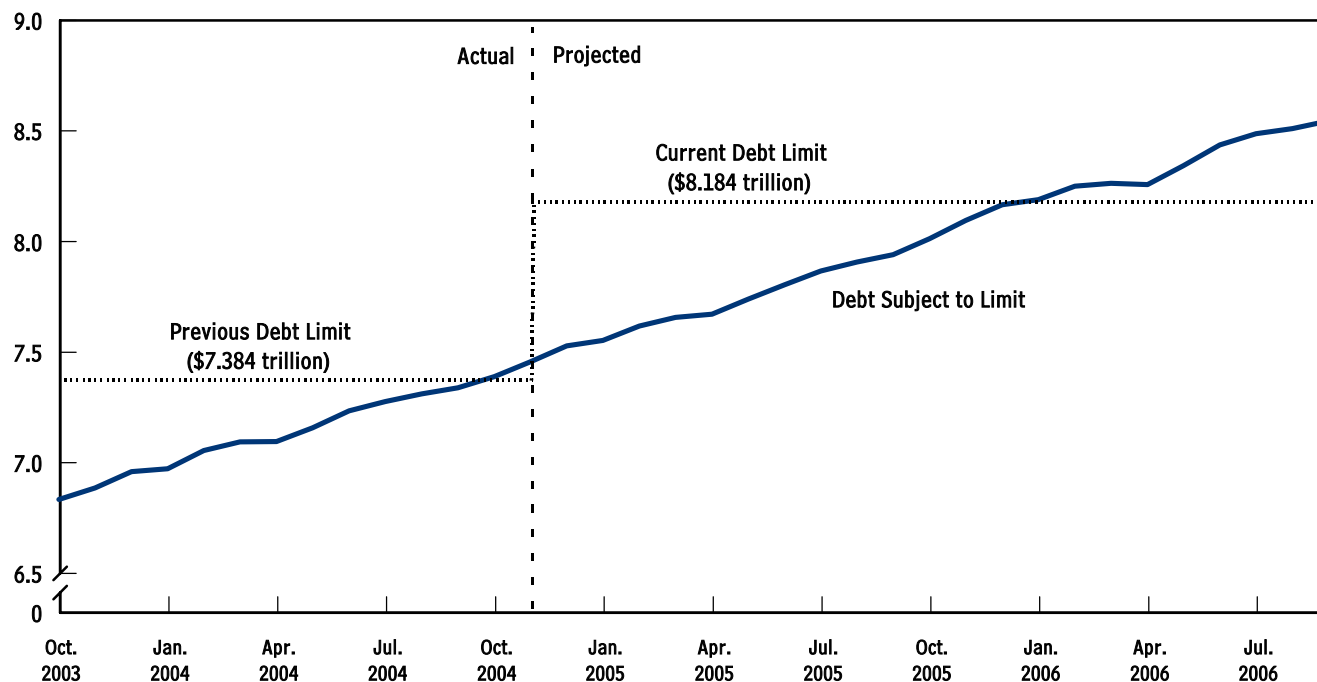
the International Monetary Fund repaid a portion of the Treasury's reserve assets.

Debt Held by Government Accounts

Besides selling securities to the public, the Treasury has issued about \$3.1 trillion in securities to various accounts of the federal government (as of the end of fiscal year 2004). All of the major trust funds in the budget and many other government funds invest in special, nonmarketable Treasury securities known as the government account series. (Trust funds are described in more detail at the end of this chapter.) Those investments are intra-governmental transactions and have no direct effect on the economy. The securities represent credits to the various government accounts and are redeemed when necessary to cover benefit payments and other expenses. In the meantime, the Treasury assigns interest earnings to the

Figure 1-5.**Debt Subject to Limit, October 2003 to September 2006**

(Trillions of dollars)



Source: Congressional Budget Office.

funds that hold those securities; such payments have no net effect on the budget.

The largest balances of such debt are in the Social Security trust funds (more than \$1.6 trillion at the end of 2004) and the retirement funds for federal civilian employees (\$632 billion). If current policies do not change, the balance of the Social Security trust funds will rise to \$4.4 trillion by 2015, CBO projects, and the balance of all government accounts will climb to \$7.1 trillion (see Table 1-5).

Gross Federal Debt and Debt Subject to Limit

Gross federal debt and its companion measure, debt subject to limit, comprise debt issued to government accounts as well as debt held by the public. The future path of gross federal debt is determined by the sum of those two components. CBO projects that under current law, gross federal debt will increase in every year of the projection period and reach almost \$12.8 trillion in 2015—roughly 73 percent more than the 2004 total of nearly \$7.4 trillion. Most of that increase reflects debt held by government accounts. Under current law, more than half

of the gross federal debt in 2015 would be held by government accounts—that is, money owed by the government to itself.

The Treasury's authority to issue debt is restricted by a statutory ceiling. Although that limit covers debt held by the public and by government accounts, it does not include debt issued by agencies other than the Treasury (such as the \$26 billion in debt issued by the Tennessee Valley Authority and the \$14 billion issued by the Federal Financing Bank). The current debt ceiling, which was set in November 2004 in P.L. 108-415, is \$8.184 trillion (see Figure 1-5). CBO estimates that under current policies, that ceiling will be reached between November 2005 and February 2006.

At that time, if a higher debt limit has not been enacted, the Treasury will have to use accounting measures to remain under the debt ceiling so it can continue to raise cash to pay for government activities. Those accounting measures—most of which have been used in the past—could include suspending the issuance of certain securities held in the Thrift Savings Plan, postponing the issu-

Table 1-6.**CBO's Baseline Projections of Trust Fund Surpluses**

(Billions of dollars)

	Actual 2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Social Security	151	169	185	205	225	242	258	273	284	293	300	304
Medicare												
Hospital Insurance (Part A)	13	16	22	24	27	29	30	27	33	28	25	22
Supplementary Medical Insurance (Part B)	-8	3	3	1	2	4	5	2	9	6	4	5
Subtotal, Medicare	5	19	24	25	30	33	34	30	42	34	30	26
Military Retirement	10	11	10	10	10	10	11	12	13	14	14	15
Civilian Retirement ^a	30	32	31	31	32	32	32	32	32	33	33	34
Unemployment	-3	11	12	9	6	4	3	3	4	4	4	5
Highway and Mass Transit	-3	-2	-3	-3	-3	-2	-2	-2	-1	-1	-1	*
Airport and Airways	*	1	1	1	2	2	3	3	4	4	5	5
Other ^b	-1	4	4	4	4	6	5	5	5	5	5	5
Total Trust Fund Surplus	189	245	265	283	305	327	344	356	382	386	390	395
Intragovernmental Transfers to Trust Funds ^c	380	406	449	496	532	571	615	662	713	767	824	885
Net Budgetary Impact of Trust Fund Programs	-192	-161	-184	-213	-227	-244	-271	-306	-332	-382	-433	-491

Source: Congressional Budget Office.

Note: * = between -\$500 million and zero.

- a. Includes the Civil Service Retirement, Foreign Service Retirement, and several smaller retirement trust funds.
- b. Primarily trust funds for Railroad Retirement, federal employees' health and life insurance, Superfund, and various veterans' insurance programs.
- c. Includes interest paid to trust funds, payments from the general fund to the Supplementary Medical Insurance program, employers' share of employee retirement, lump-sum payments to the Civil Service and Military Retirement Trust Funds, taxes on Social Security benefits, and smaller miscellaneous payments.

ance of state and local government series securities, delaying the issuance of securities to the Civil Service Retirement Trust Fund, or withdrawing federal securities from the Exchange Stabilization Fund. In recent years, when the Treasury has bumped into the debt ceiling, such accounting maneuvers have enabled it to remain below the debt limit for one to three months. (However, unlike in the past two instances, the Treasury will be unable next time to clear significant room under the debt ceiling by swapping securities with the Federal Financing Bank. The bank is limited to issuing \$15 billion of its own debt; it has already issued \$14 billion, which is currently held by the Civil Service Retirement and Disability Fund.)

Trust Funds and the Budget

The federal budget includes nearly 175 trust funds, although fewer than a dozen account for the vast share

of trust fund dollars. Among the largest are the two Social Security trust funds (the Old-Age and Survivors Insurance Trust Fund and the Disability Insurance Trust Fund) and the funds dedicated to civil service retirement, Hospital Insurance (Part A of Medicare), and military retirement (see Table 1-6). Trust funds have no particular economic significance. They do not hold separate cash balances; instead, they function primarily as accounting mechanisms to track receipts and spending for programs that have specific taxes or other revenues earmarked for their use.

When a trust fund receives payroll taxes or other income that is not currently needed to pay benefits, the Treasury credits the fund and uses the excess cash for other government purposes. As a result, the government borrows less from the public than it would otherwise. The process is reversed when revenues for a trust fund program fall short

of its expenses. In that case, the government raises the necessary cash by increasing taxes, reducing spending, or borrowing more than it would otherwise.

Including the cash receipts and expenditures of trust funds as well as of other federal programs in the budgetary totals is useful for assessing how federal activities affect the economy and capital markets. Thus, CBO, the Office of Management and Budget, and many other fiscal analysts focus on the total deficit or surplus rather than on the deficit or surplus without particular trust funds.

In CBO's current baseline, trust funds as a whole are projected to run a surplus of \$245 billion in 2005. That balance is somewhat misleading, however, because trust funds receive much of their income in the form of transfers from other parts of the budget. Such intragovernmental transfers reallocate costs from one section of the budget to another; they do not change the total deficit or the government's borrowing needs. Consequently, they have no effect on the economy or on the government's future ability to sustain spending at the levels indicated by current policies.

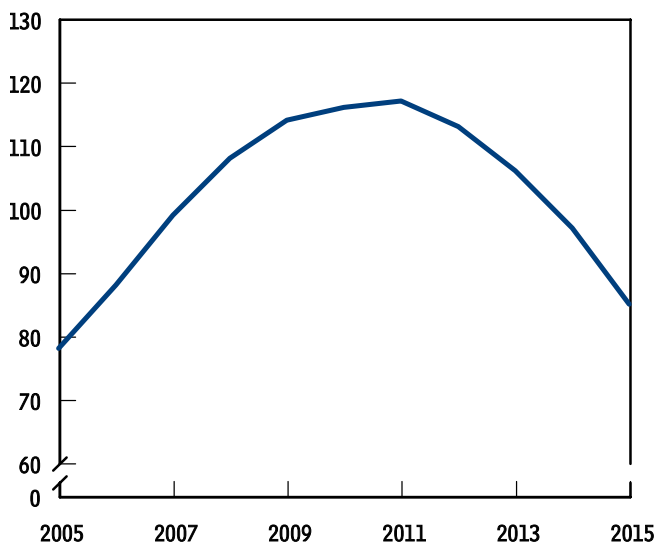
For 2005, those intragovernmental transfers are estimated to total \$406 billion. The largest involve interest credited to trust funds on their government securities (\$161 billion in CBO's projections), transfers of federal funds to Medicare for Supplementary Medical Insurance (\$114 billion), contributions by government agencies to retirement funds for their current and former employees (\$48 billion), and payments from the general fund to Social Security (\$14 billion). With intragovernmental transfers excluded and only income from sources outside the government counted, the trust funds as a whole are projected to run a deficit throughout the projection period, growing from \$161 billion in 2005 to \$491 billion in 2015.

Although the budgetary impact of the aging of the baby-boom generation will not be fully felt during the current projection period, CBO's baseline provides initial indica-

Figure 1-6.

Annual Social Security Trust Fund Surpluses, Excluding Interest

(Billions of dollars)



Source: Congressional Budget Office.

tions of the coming budgetary pressures. Charting the differences over the next 10 years between projected receipts and outlays for the Social Security trust funds (excluding intragovernmental interest payments) illustrates those pressures. Receipts are projected to exceed expenditures in each year of the period, but under current policies, the amount by which they do so will decline from more than \$100 billion between 2008 and 2013 to about \$85 billion in 2015 (see Figure 1-6). At that point, Social Security outlays will be growing by about 6 percent per year, but noninterest receipts will be growing by about 4.5 percent. Thus, in CBO's baseline projections, the capacity of the Social Security trust funds to offset some of the net deficit in the rest of the budget—as they do now—will begin to dwindle during the coming decade. Shortly thereafter, Social Security is projected to begin adding to deficits or reducing surpluses.

